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In The
Supreme Court of the United States

THE STATE OF CALIFORNIA, et al.,
Petitioners,
v.
GEORGE E. SCHULMAN,
Chapter 7 Trustee,
Respondent.

On Petition For A Writ of Certiorari
To the United States Court of Appeals
For the Ninth Circuit

PETITIONERS' REPLY BRIEF

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PETITIONERS' REPLY BRIEF

Pursuant to Rule 15.6 of the Rules of the Court, Petitioners submit the following brief in reply to the Trustee's Brief in Opposition ("Opp. Brief"). The Trustee mistakenly argues that certiorari is not warranted because the Ninth Circuit opinion has not yet resolved the question presented by Petitioners. Opp. Brief at 9. This is a misreading of the Petition, as well as the law of recoupment as it applies in the context of sovereign immunity. This Court's intervention is necessary because the Ninth Circuit has indeed created a rule of waiver that threatens to nullify the constitutional protections provided by the Eleventh Amendment.

This case arises under the following circumstances. While operating their gasoline service stations, the debtors were required to pay fees into a state-administered fund (the "Fund"). The amount of fees is based on the number of gallons of fuel stored in underground tanks. Appendix to Petition for Writ of Certiorari ("Petition App."), p. 5.

The State's proof of claim in the bankruptcy proceeding sought unpaid Fund fees. The holding from *Gardner v. New Jersey*, 329 U.S. 565 (1947), would allow the Trustee to adjudicate issues relating to this claim – *i.e.*, whether the amount of fees being claimed is proper. Under the Ninth Circuit decision, however, the Trustee was also permitted to sue the State Water Resources Control Board ("State Board") regarding a matter not necessary to determine the State's entitlement to Fund fees. In this separate legal action, the Trustee is seeking a determination regarding eligibility to obtain

reimbursement from the Fund -- a matter that will not operate to defeat or diminish the State's entitlement to receive payment for unpaid fees.

Although styled as typical state law writ of mandate, the Trustee's mandamus action against the State Board ultimately seeks the payment of money from a fund in the State Treasury.[1] In attempting to minimize the necessity of certiorari, the Trustee's refrain is that the State's sovereign immunity has not been compromised because it is not yet known whether, or how much, money will be ordered paid from this fund in the State's Treasury. Opp. Brief at 11.

Petitioners do not dispute that whether "affirmative" relief is being sought against the State is one factor to consider in an analysis to determine if a recoupment claim against a State should be allowed to proceed over the State's Eleventh Amendment objection. But the question of affirmative relief is not the only element to be considered in whether to allow such an action to be heard against a nonconsenting State.

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1. The Trustee's reference to the fact that the Fund "and not the California treasury" would pay the reimbursement claims (Opp. Brief at 4) is an indirect attempt to revive an issue rejected by the bankruptcy court and the Ninth Circuit. Although the District Court had found that the Fund was not an "arm of the State," the Ninth Circuit decided otherwise, Pet. App., pp. 29-35, and the Trustee has not sought certiorari on this issue. The Fund is indeed part of the State Treasury. Moreover, the State Board – a state agency – is the sole respondent in the Trustee's mandamus action seeking to overturn the Board's decision to deny the reimbursement claims.

The purpose of the Eleventh Amendment is twofold. "The Eleventh Amendment does not exist solely in order to 'preven[t] federal-court judgments that must be paid out of a State's treasury,' . . . ; it also serves to avoid the 'indignity of subjecting a State to the coercive process of judicial tribunals at the instance of private parties.'" *Seminole Tribe of Florida v. Florida*, 517 U.S. 44, 58 (1996)(quoting *Hess v. Port Authority Trans-Hudson Corporation*, 513 U.S. 30, 48 (1994) and *Puerto Rico Aqueduct and Sewer Authority v. Metcalf & Eddy, Inc.*, 506 U.S. 139, 146 (1993)). That the Trustee is seeking relief through a petition for writ of mandate does not render the Eleventh Amendment inapplicable. The Eleventh Amendment immunity protects states from suit regardless of the nature of the relief sought. *Pennhurst State School & Hospital v. Haldeman*, 465 U.S. 89, 100 (1984).

The Trustee's discussion of further proceedings that have taken place in the bankruptcy court subsequent to that court's rejection of the State's assertion of sovereign immunity establishes that any focus on the monetary amount of the claims against the State Board is misplaced. Opp. Brief at 6. In ruling on the mandamus action -- prior to the District Court or the Ninth Circuit hearing the State's sovereign immunity appeal -- the bankruptcy court directed the State Board to hold new administrative proceedings to reconsider all of the claims for reimbursement from the Fund. More importantly, it ordered the State Board not to consider the debtors' misconduct as an eligibility criterion for payment, even though the claims were filed by the debtors pre-petition. *Id.* This type of intrusion into the State's administrative

process is as much a violation of the State's Eleventh Amendment immunity as an affirmative monetary recovery. *See Sacred Heart Hospital of Norristown v. Commonwealth of Pennsylvania (In re Sacred Heart Hospital)*, 204 B.R. 132, 139-140 (E.D.Pa. 1997), *aff'd.* 133 F.3d 237 (3rd Cir. 1998) (bankruptcy court's order directing a state agency to hold an administrative hearing and denying its single defense to the debtor's claim violated the state's sovereign immunity).

The very error in the Ninth Circuit's opinion, and the Trustee's analysis, is the conclusion that the Eleventh Amendment does not forbid a separate action against a State so long as the action is "logically related" to the State's bankruptcy claim and no determination is made as to the extent of monetary relief. This ignores the Court's limitation in *Gardner v. New Jersey*, 329 U.S. 565 (1947), that any "waiver" by filing a proof of claim is limited to "adjudication of the claim." *Gardner*, 329 U.S. at 574. The rule from *Gardner*, and the Circuits that follow *Gardner*,[2] is straightforward. Where a State files a proof of claim in a bankruptcy proceeding, the process of proof, allowance and distribution regarding that claim is not a "suit against the State" because "[n]o judgment is sought against the State." *Gardner*, 329 U.S. at 574.

The Trustee makes a passing reference to *Gardner*

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2. *Arecibo Community Health Care, Inc. v. Commonwealth of Puerto Rico*, 244 F.3d 241, 244-145 (1st Cir. 2001); *Jones v. Yorke (In re Friendship Medical Center)*, 710 F.2d 1297, 1301 (7th Cir. 1983); *In re Dept. of Energy Stripper Well Exemption Litigation (Anadarko v. New Mexico)*, 956 F.2d 282, 285 (Temp.Emerg.Ct.App. 1992).

as permitting "the assertion of defenses" when a State files a proof of claim. Opp. Brief at 10. This is an admission by the Trustee that the extent of any "waiver" of sovereign immunity when the State files a claim in federal court is a defensive recoupment action. It is precisely on this point, however, that the Ninth Circuit deviates from the Circuits following *Gardner* and extends the doctrine of waiver in a manner that is unconstitutional and unwarranted.

Recoupment is a doctrine that is recognized by the courts precisely because it is in the "nature of a defense." *See Bull v. United States*, 295 U.S. 247, 262 (1935).[3] This well-established rule, as applied against a sovereign, is entirely consonant with *Gardner* Where a governmental entity seeks relief against a debtor's estate by submitting a proof of claim, the government has only "consented" to allow the court to hear matters involving the proof of, and defenses to, that claim. *Gardner*, 329 U.S. at 574.

The Ninth Circuit's opinion expressly recognized that it was adopting a rule of implied waiver of sovereign immunity beyond that allowed in *Gardner*. In authorizing

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3. The Trustee mischaracterizes the holding in *Bull v. United States*, 295 U.S. 247 (1935) as authorizing a counterclaim against a sovereign where "both claims involved taxation of proceeds from a single fund." Opp. Brief at 15. *Bull* does not stand for such a broad proposition. While the Court in *Bull* correctly recites that recoupment is "defensive" in nature, a more recent decision of the Court has emphasized that the type of equitable recoupment recognized in *Bull* "will lie only where the Government has taxed a single transaction, item, or taxable event under two inconsistent theories." *United States v. Dalm*, 494 U.S. 596, 605 n.5 (1990). The Trustee herein is not alleging inconsistent or contradictory theories of taxation.

a claim to be asserted against the State solely because that claim is "logically related" to the State's claim for unpaid taxes and fees, the Ninth Circuit set forth a "broader waiver" rule than set forth in *Gardner*. Petition App., pp. 18-19.

> Although the waiver found constitutional in *Gardner* was limited to the state's own claim, and thus narrower than the same-transaction-or-occurrence standard, ...

Petition App., p. 18.

Stated succinctly, *Gardner* represents a proper recoupment analysis because it narrowly limits any "waiver" of sovereign immunity to adjudicating and defending against the State's claim. The Ninth Circuit's opinion holds that if a separate action against the State is "logically related" to the State's bankruptcy claim, the Eleventh Amendment does not require that it be defensive in nature. Such a ruling overlooks the fact that by ignoring the requirements of defensive recoupment and extending *Gardner* to find a "broad waiver" of sovereign immunity, the Circuit has placed itself in clear conflict with this Court's Eleventh Amendment jurisprudence.

The Trustee seeks to find some inconsistency between the question presented in the Petition and the position taken by the State at the Ninth Circuit -- *i.e.*, "when the State files a proof of claim, it does consent to the bankruptcy court determining a recoupment claim arising out of the 'same transaction or occurrence' as the State's proof of claim." *See* Opp. Brief at 13. There is no

inconsistency here. An acknowledgment by the State that an allowable defensive recoupment claim must arise out of the "same transaction or occurrence" is not an admission that such a claim need not satisfy the more primary standard of being defensive in nature. As our Opening Brief before the Ninth Circuit pointed out:

> Regardless of whether the mandate petition is deemed to arise out of the "same transaction or occurrence," the bankruptcy court cannot grant relief to the Trustee because, by definition, the mandate petition is not in the nature of a defensive recoupment action.

Opening Brief of Appellants California State Water Resources Control Board *et al.* at 42.

The Ninth Circuit improperly found a broad waiver of the Eleventh Amendment when it applied an "increasingly liberal" standard to the "same transaction or occurrence" test. *See College Savings Bank v. Florida Prepaid Postsecondary Education Expense Bd.*, 527 U.S. 666, 675 (1999) (the test for waiver is a "stringent" one). This was not its only error of constitutional dimension, however. It made a far greater incursion into the States' sovereign immunity when it rejected the rule established by the Court in *Gardner*, a rule that is consistent with the parameters of proper defensive recoupment. By definition, and as applied by the bankruptcy court, the Trustee's mandamus action is not "defensive" in any sense of the word.

As Montana and the other states and territories that have supported the Petition recognize in their amicus brief:

> State revenue departments routinely file proofs of claim in bankruptcy to collect unpaid taxes. As this Court has noted, "[t]he power to tax 'is an incident of sovereignty. . . .'"

Brief of Amicus Curiae States of Montana, *et al.* at 1-2 (citing *International Harvester Co. v. Wisconsin Dept. of Taxation*, 322 U.S. 435, 444 (1944)). The Ninth Circuit opinion subjects a state agency to a suit that is not defensive in nature, solely because the state revenue-collecting entity has sought to recover unpaid taxes. This is impermissible under the Eleventh Amendment because it is a "deemed" waiver of sovereign immunity "implied" from the exercise of sovereign functions – *i.e.*, the right to impose and collect taxes.

If allowed to stand, the Ninth Circuit's opinion with respect to waiver will allow States to be sued for any cause of action that has any arguable relationship to the State's demand for unpaid taxes. Such a rule would dilute the constitutional protections inherent in the Eleventh Amendment. In contrast, the narrow holding in *Gardner* is consistent with the Court's Eleventh Amendment jurisprudence, which rejects the concept of an implied or constructive waiver of sovereign immunity. The intervention of the Court is necessary to establish a uniform rule on this important question.

CONCLUSION

The petition for writ of certiorari should be granted.

Respectfully submitted,

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